No. 83-1961 (1)

IN THE

Supreme Court of the United States

October Term, 1984

LANDRETH TIMBER COMPANY,
Petitioner,

v.

IVAN K. LANDRETH, LUCILLE LANDRETH, THOMAS E. LANDRETH, IVAN K. LANDRETH, JR., AND KATHLEEN LANDRETH,
Respondents.

ON WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

BRIEF OF RESPONDENTS

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QUESTION PRESENTED

Is the privately negotiated sale of a closely held business, effectuated by the transfer of 100% of the company's stock to a sophisticated corporate purchaser which assumes complete control over the business, a transaction in securities under the Securities Act of 1933 and the Securities Exchange Act of 1934?[1]

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[1] Hereinafter the Securities Act of 1933, 15 U.S.C. §§ 77a *et seq.* (1983), and the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a *et seq.* (1983), are individually referred to as the "1933 Act" or "1934 Act," and collectively referred to as "the Acts."

PARTIES INVOLVED

Petitioner Landreth Timber Company ("LTC II") is a Delaware corporation. LTC II is the successor in interest to B&D Company, Inc. ("B&D"),[2] which purchased 100% of the shares of Landreth Timber Company, Inc. ("LTC I") from the respondents. LTC II was the plaintiff below.

Respondents are Ivan K. Landreth, Lucille Landreth, Thomas E. Landreth, Ivan K. Landreth, Jr. and Kathleen Landreth ("the Landreths"), formerly owners of all of the stock of LTC I, a closely held corporation. The Landreths were the defendants below.

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[2] Contrary to the repeated suggestion in Petitioner's Brief, Messrs. Bolten and Dennis, the largest individual shareholders of B&D, are not parties to this action. The sole petitioner herein is LTC II, a corporate entity which is the successor in interest to B&D, a corporation which acquired 100% of the stock of LTC I. *See* n. 12, *infra*.

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BRIEF OF RESPONDENTS

I. STATEMENT OF THE CASE

A. The Narrow Scope of Factual Inquiry.

The sole question before this Court is whether the sale of a family-owned sawmill business to a sophisticated corporate purchaser, accomplished by the transfer of 100% of the business' stock, constitutes a transaction in securities within the meaning of the Acts. The facts pertinent to this inquiry relate solely to the economic realities of the underlying transaction, i.e., whether the transaction involves an investment of money in a common enterprise premised on an expectation of profits to be derived from the entrepreneurial or mangerial efforts of others. The record below[3] contains a number of admitted facts[4] which, standing alone, are sufficient to resolve these issues.

[3] Citations to the record from the District Court for the Western District of Washington as certified by the Clerk of the Court of Appeals for the Ninth Circuit, appear as ("R. [Record number] at [page within document]"). The title of, and an identifying reference to, each cited document is contained in Appendix A to this Brief.

[4] In its application of the "economic realities" test to this transaction, the district court relied on Defendants' Requests to Plaintiff for Admissions of

In its brief, LTC II makes extensive allegations of fraud and misrepresentation, all of which are denied by the Landreths. There have been *no* findings of fraud or misrepresentation in the proceedings below, and LTC II's allegations are vigorously contested by the Landreths.[5]

These allegations, while misleading and susceptible to rebuttal, are totally irrelevant to the issue now before this Court. *See United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837, 859 (1975). Thus, the analysis of critical facts contained herein will be directed solely to the question of whether this was a transaction in "securities" within the meaning of the Acts.

B. Analysis of Critical Facts.

The Landreths were the owners of LTC I, a sawmill business located in eastern Washington. Prior to the sale of LTC I to B&D, the Landreths owned all of its outstanding stock (J.A. 182). The single most valuable asset of the business was a lumber manufacturing plant, which had been

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[footnote continued]

Fact Concerning Post-Closing Corporate Control and Responses Thereto (the "admissions of fact") (J.A. 178-335). LTC II's admissions before the district court, as discussed herein, not only firmly establish that the criteria of the "economic realities" test were not met, but also directly contradict several of the factual allegations contained in Petitioner's Brief.

[5] LTC II's allegations of fraud and misrepresentation are without merit. Because these claims are irrelevant to the question currently before this Court, they are addressed summarily herein. However, when these issues are heard on their merits, the evidence will show that there were no misrepresentations or breaches of warranties by the Landreths regarding: (1) the capacity of the mill; (2) the amount of overrun which could be produced by the mill; (3) the estimated date of completion of mill reconstruction; or (4) the cost of completion. Furthermore, the evidence will show that the problems encountered by LTC II were the result of LTC II's own mismanagement, improper reconstruction of the mill after closing of the sale, unnecessary expenditures, fraud by LTC II's own mill manager, and LTC II's own poor marketing decisions.

partially destroyed by fire (J.A. 182). At the time of the sale to B&D, the mill was under reconstruction and was not manufacturing lumber (J.A. 182).

In 1976, the Landreths listed their sawmill business for sale.[6] Jack Branch ("Branch"), a timber broker[7] who later became a shareholder and represented himself to be an officer of LTC II, learned of the mill from a real estate broker with whom the Landreths had listed the property (R. 69 at 242; R. 93 at 157). Branch mentioned the sawmill to Al Willard, who subsequently contacted Samuel Dennis III ("Dennis"), with whom he had worked on other business transactions (J.A. 96-100). Dennis was a senior partner and tax attorney with the Boston law firm of Hale & Dorr, and had been a principal in Standex International Corporation, a publicly-traded company which had acquired over 100 businesses in a twenty-five year period (R. 69 at 5, 141).

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[6] Contrary to LTC II's assertion, the Landreths did not list "stock" for sale in 1976. To the contrary, the listing cited by LTC II actually was placed with a limited number of real estate and business brokers in Oregon and Washington and offered a "lumber manufacturing facility" (R. 93 at 158; R. 70 at 2). Such listing further stated that the Landreths were offering their "business for sale" and that they would consider selling by transfer of stock or a sale of assets comprising the lumber manufacturing facility. There is no evidence that the mill was "widely offered" as alleged by LTC II. Pet. Br. at 10.

[7] Throughout its brief, LTC II refers to an unnamed "broker," implying that he was an agent of the Landreths. *See, e.g.*, Pet. Br. at 3, 5. This is untrue. Dennis, the key member of the purchasing group, after learning the mill was for sale, contacted Branch, a timber broker and president of Timber West, Inc., asking that he serve as Dennis' agent in negotiating a purchase of the mill. Branch was promised a 25% ownership interest in the acquiring corporation if negotiations were successful, and was led to believe that Timber West would receive a monthly management fee for overseeing mill operations (J.A. 103-04; R. 69 at 174-75, 244-45). Branch assisted in negotiating the purchase on Dennis' behalf, retained outside consultants to evaluate the mill on behalf of Dennis, and hired the new mill manager, Phil Cook, to replace Ivan Landreth at closing (*see, e.g.*, J.A. 105, 135, 292-95). In return, Branch received shares of stock in the acquiring company and represented that he was its vice-president (J.A. 185, 309; R. 69 at 246-47).

During the summer of 1977, Dennis initiated negotiations with Ivan Landreth ("Landreth") (R. 69 at 181-82). Those negotiations led to the execution of a Stock Purchase Agreement on October 6, 1977 pursuant to which Dennis, as an accommodation buyer, agreed to acquire the Landreths' sawmill business by transfer of all of the stock of LTC I (J.A. 206-63). Prior to Dennis' execution of this Stock Purchase Agreement, the purchaser conducted a comprehensive investigation of the assets and liabilities of LTC I including: (1) personal visits to the mill by Dennis, Branch, and the purchaser's new mill manager, Phil Cook ("Cook"), (2) a review of books and records by a certified public accountant, Peter Townsend, (3) an appraisal of the mill facility by the engineering firm of Pease & Beadling, and (4) a review of the mill by Robert Ingram, a loan officer with one of the banks financing the purchase, who was familiar with sawmill operations (J.A. 115-34; R. 69 at 161, 171, 174-75, 179-80, 310-14; R. 69 at 93-122). The sale closed on November 17, 1977 (J.A. 183).

At closing, under an "Assignment of, and Amendment to Stock Purchase Agreement" (the "Amended Stock Purchase Agreement"), B&D was substituted for Dennis as the purchaser of LTC I (J.A. 183, 204). B&D had been formed by the purchasing group for federal tax reasons, and under the terms of an Agreement and Plan of Merger dated November 17, 1977, LTC I was merged into B&D, which then continued to conduct the sawmill business under the name "Landreth Timber Company, Inc." (J.A. 183-84).

The Stock Purchase Agreement and Amended Stock Purchase Agreement were drafted by a cadre of lawyers in Seattle and Boston who had been retained by Dennis (J.A. 278, 300; R. 69 at 152-58, 228-29). The agreements contained extensive warranty provisions and other protections for the purchaser (J.A. 206-63). Noticeable by way of absence, however, was any reference to the federal securities laws in either the text of the purchase agreements or the written or oral negotiations between the parties.

LTC II's admissions of fact before the district court unequivocally demonstrate the following: (1) there was absolutely no "common enterprise" among the sellers and the purchaser after closing; and (2) the purchaser assumed complete control of the enterprise at closing, and thereafter operated the business without reliance on the Landreths. Specific admissions of fact by LTC II, many of which directly contradict allegations now raised in Petitioner's Brief, include the following:

1. Under the Stock Purchase Agreement the Landreths agreed to sell 100% of the stock of LTC I to a corporation to be formed by the purchasing group, and Dennis executed that Agreement as an accommodation buyer on behalf of the corporation (J.A. 182, 204).
2. The purchasing entity, B&D, was formed "solely for federal tax reasons" in order to effectuate the purchase of the Landreths' stock (J.A. 204).
3. Under the Stock Purchase Agreement the Landreths agreed to resign as officers and directors of LTC I, and such resignations in fact occurred (J.A. 184).
4. None of the Landreths became officers, directors, shareholders, or employees of the acquiring company, or held any other interest in B&D (J.A. 184).
5. None of the Landreths became officers, directors, shareholders or had any other ownership interest in LTC II (J.A. 185).
6. None of the Landreths had a right to share in the profits or losses of LTC II (J.A. 186, 204).
7. The purchasing group selected and retained its own mill manager, prior to closing. Cook assumed the position of general manager of LTC II at closing (J.A. 186-88).
8. After closing Landreth's role was limited to that of a consultant retained by LTC II pursuant to a consulting agreement (J.A. 188).

9. Under the consulting agreement, Landreth had no right to share in profits, receive commissions, or obtain any other compensation dependent upon the profitability of LTC II (J.A. 189).

10. Landreth's post-closing employment was terminable at will by LTC II (J.A. 190).

11. After closing, Landreth did not possess authority to make decisions for LTC II regarding hiring or firing employees, writing checks, setting salaries, entry into log purchase contracts,[8] product mix, sale prices, expenditures for equipment acquisition and maintenance, reconstruction and design of the mill, or any related matters (J.A. 191-98).

12. On the other hand, LTC II's mill manager, had the authority to and did make all of the above decisions (J.A. 191-98).

13. By letter dated December 19, 1977, approximately one month after closing, Branch, vice president of the purchaser, wrote to Cook, LTC II's mill manager, unequivocally telling him that Landreth was no longer involved in the acquired company:

> *Ivan Landreth and his sons have sold 100% of the stock of Landreth Timber Company to B&D Corporation* which subsequently will change its name back to Landreth Timber Company. Ivan Landreth has no stock whatsoever in the company and has been retained on an interim basis for perhaps one to three months as a consultant on matters relating to the orderly transition in sales, contracts, customers, etc. *In the event any of your personnel have any*

[8] LTC II's admissions of fact before the district court belie its current assertion that Landreth bid on Forest Service sales after closing. Pet. Br. at 8-9. In fact, Landreth lacked the authority to make such commitments, which instead were the exclusive responsibility of LTC II's own mill manager (J.A. 192).

> *vague notions or concerns as to whether Ivan is still involved in the company, please be sure that he is not* and although he is still around the mill, more or less tidying up his affairs, *we will have no further use for his services in a short period of time.*
>
> (J.A. 297-98) (emphasis added).

14. In a letter dated January 10, 1978, less than two months after LTC II was sold, Branch notified Landreth that his employment as a consultant was terminated (J.A. 201, 309).

In summary, as of the date of closing, the purchaser obtained complete ownership of the Landreths' sawmill business, and exerted absolute control over the business. After closing there was no element of common enterprise between the purchaser and the Landreths.

C. Summary of Proceedings Below.

LTC II commenced this action in November, 1978, alleging federal securities law violations, as well as numerous state and common law claims. Thereafter, LTC II filed a virtually identical state court action,[9] excluding the claims for violation of the federal securities laws. The Landreths moved for summary judgment in the district court action on the basis that the sale of the Landreths' sawmill business was not a transaction in "securities" under the Acts, and therefore the Court lacked subject matter jurisdiction over LTC II's claims.

On February 27, 1981, Judge Barbara Rothstein concluded that the economic realities of the underlying transaction should be examined in determining whether the sale of the Landreths' sawmill business was a transaction

[9] *Landreth Timber Co.* v. *Ivan K. Landreth et al.*, State of Washington, County of King, Cause No. 80-2-11740-8.

in securities under the Acts (J.A. 173-77). The court subsequently conducted a hearing directed at the issue of the purchaser's assumption of post-closing control — i.e., whether under the "economic realities" test LTC II expected profits from the entrepreneurial or managerial efforts of others, or whether LTC II itself controlled the enterprise and determined the outcome of its investment after closing (J.A. 174-75). On April 29, 1981 the district court issued an order granting summary judgment in favor of the Landreths;[10] and, on May 27, 1981, dismissed LTC II's claims.[11]

On March 7, 1984, the United States Court of Appeals for the Ninth Circuit affirmed the district court's decision. *Landreth Timber Co.* v. *Landreth*, 731 F.2d 1348 (9th Cir. 1984). The Court applied the "economic realities" test to determine whether the sale of 100% of the shares of LTC I stock constituted a transaction in "securities." The Ninth Circuit concluded that, under any formulation of the sale of business doctrine, the economic realities of the Landreth transaction left no doubt that it was the sale of a business, not an investment in securities. 731 F.2d at 1353.[12]

II. SUMMARY OF ARGUMENT

In determining whether the sale of a business through the transfer of 100% of a corporation's stock to a single corporate purchaser is a sale of a "security," this Court must adhere to the principles which have guided all of its decisions defining a "security" under the Acts. This Court has

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[10] The Court's Order Granting Summary Judgment is attached as Appendix B to this brief.

[11] The state court action remains pending.

[12] The Ninth Circuit also rejected the attempt of Dennis and the estate of John Bolten to intervene on appeal as individual parties plaintiff. 731 F.2d at 1353. This renders even more transparent LTC II's attempts to suggest in its brief that Dennis and Bolten as individuals, rather than a corporate entity, were the purchasers of the shares of LTC I. *See, e.g.*, Pet. Br. at 42-43.

developed, and consistently applied, an "economic realities" test which embodies the essential attributes of a "security": i.e., whether there is an investment in a common enterprise, in reliance upon an expectation of profits to be derived from the entrepreneurial or managerial efforts of others.

In applying this test, the Court is not bound by the name appended to an instrument. "Stock" is only one of a number of different instruments listed within the definition of a "security" under the Acts which, depending on the economic realities underlying the transaction, may constitute a "security." This Court has expressly rejected the literal approach now urged by LTC II and the S.E.C., and has refused to adopt an inflexible rule barring inquiry into the economic realities underlying a transaction.

Application of the "economic realities" test to the sale of a business through the transfer of 100% of its stock is consistent with the legislative intent of the Acts to regulate and prevent abuses in publicly traded securities. The primary concern of the federal securities laws is the protection of investors who provide venture capital and relinquish control over their investment, expecting to receive profits from the entrepreneurial or managerial efforts of others.

The transactional analysis embodied in the "economic realities" test has been consistently applied by this Court in numerous contexts involving a variety of different instruments, including investment contracts, withdrawable shares in a savings institution, stock in a housing cooperative, an employee pension plan, a certificate of deposit, and a privately negotiated profit-sharing agreement. In all of its decisions defining a security, the Court has looked outside the instrument itself and analyzed the economic realities underlying the transaction.

Applying the economic realities test to the facts of this case, the privately negotiated sale of LTC I, accomplished through the transfer of 100% of LTC I's stock to B&D, did not constitute the sale of a "security" under the Acts because: (1) there was no common enterprise among the purchaser and

sellers, and (2) the purchaser assumed and exercised complete control over the business, and thus did not rely on the managerial or entrepreneurial efforts of others.

Policy considerations also support the conclusion that the sale of LTC I is not a transaction in securities. All of the Court's prior decisions have applied the "economic realities" test, regardless of the type of instrument involved. The applicability of the "economic realities" test to the sale of a business accomplished through the transfer of stock is consistent with the intent of the Acts to protect passive investors who lack the ability to control the outcome of their investment.

By contrast, adoption of the "traditional characteristics" test proposed by LTC II and the S.E.C., which precludes inquiry into the underlying economic realities of a transaction and would determine the applicability of the securities laws based upon whether a document has the "traditional attributes" of an instrument enumerated in the statute, is contrary to the language and purpose of the Acts. The "traditional characteristics" test has never been applied by this Court, which instead has chosen to determine the existence of a security based upon the transactional context. The adoption of the "traditional characteristics" test is unworkable as applied to several instruments named in the Acts, (e.g., notes), and ultimately would require the creation of a number of different tests depending upon the *instrument* involved, ignoring the economic realities of the underlying *transaction.*

Courts can apply the "economic realities" test in a fair and predictable manner. When the underlying transaction involves the sale of 100% of a corporation's stock, there is neither a common enterprise nor reliance on the efforts of others, and, as a matter of law, there is no transaction in securities subject to the Acts. If the sale of stock involves a transfer of less than 100% ownership of the business enterprise, then a court can evaluate the economic realities of the underlying transaction based upon the record before

it if there is no material issue of fact, or by way of an evidentiary hearing if a factual issue exists.

The application of the "economic realities" test to the sale of a business is consistent with the intent of Congress to provide a remedy for passive investors, while excluding from coverage entrepreneurs who purchase and actively control a business, for whom Congress intended no special protection under the Acts.

III. ARGUMENT

A. The Structure of the Acts Requires Examination of the Transactional Context in Order to Determine the Existence of a Security.

The definitions found in both the Securities Act of 1933 and the Securities Exchange Act of 1934 are the starting point for determining whether a given transaction involves a "security" under the Acts. 15 U.S.C. § 77b; 15 U.S.C § 78c. "Stock" is merely one of approximately seventeen instruments identified within the definition of a "security," and is given no more dignity or emphasis than any other instrument under the Acts. Stock is merely one type of instrument which, depending upon its transactional context, *may* constitute a "security."[13] Congress left it to the courts to identify the specific criteria which distinguish securities from non-securities depending upon the economic realities of the underlying transaction. *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837, 847-48 (1975).

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[13] *See, United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837, 850 (1975). The need for analysis of the transactional context in which the enumerated instrument is used is emphasized by the fact that the term "note" is the first listed instrument in the definitional sections of the Acts. While an instrument with all the traditional characteristics of a note may constitute a security, in many instances such instrument will not fall within the scope of the Acts. Section III.E.2, n.27, *infra.*

The definitional sections of the Acts are preceded by the phrase "unless the context otherwise requires. . . ." 15 U.S.C. § 77b; 15 U.S.C. § 78c. If LTC II's literalist interpretation of the Acts is correct, requiring the Court to determine the existence of a security solely on the basis of whether a named document has the traditional characteristics of an instrument identified in the Acts, then this statutory language would be superfluous. On the contrary, this Court has indicated that the "context clause" in the Acts is of substantial importance, requiring an analysis of the economic realities of the underlying transaction in order to determine whether a security exists.

> We have repeatedly held that the test is "what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect." *S.E.C.* v. *United Benefit Life Insurance Co.*, 387 U.S. 202, 211 (1967), quoting *S.E.C.* v. *C.M. Joiner Leasing Corp., supra*, at 352-353.
>
> The broad statutory definition is preceded . . . by the statement that the terms mentioned are not to be considered securities if "the context otherwise requires. . . ."

Marine Bank v. *Weaver*, 455 U.S. 551, 556 (1982). Thus, based upon this analysis of the statute, the Court in *Marine Bank* held that an instrument enumerated in the 1934 Act was not a "security" when viewed in its *transactional context. Id.* at 560 n.11.

B. The Legislative Intent in Promulgating the Acts Was to Protect Passive Investors Who Provide Venture Capital in Reliance on the Entrepreneurial or Managerial Efforts of Others.

The issue before this Court is whether the Acts should be applied to a transaction involving the sale of a business where there is no common enterprise among sellers and purchaser and where the purchaser assumes complete control over the operation of the business. As in all cases of statutory

construction, it is necesary for the Court to interpret the definitional provisions of the statute in light of the purposes Congress sought to serve.[14]

The purchaser of an entire business is not within the class of investors whom the Acts sought to protect.[15]

> The focus of the Acts is on the capital market of the enterprise system: the sale of securities to raise capital for profit-making purposes, the exchanges on which securities are traded, and the need for regulation to prevent fraud and to protect the interest of investors.

United Housing Foundation, Inc. v. *Forman*, 421 U.S. 837, 849 (1975).

This view is supported by the legislative history of the Acts, which is replete with concern for the protection of passive investors. In adopting the 1933 Act, Congress sought to eliminate serious abuses in the largely unregulated securities market and to:

> [R]eturn to a clearer understanding of the ancient truth that those who manage banks, corporations, and other agencies handling or using other peoples' money are trustees acting for others.

H.R. Rep. No. 85, 73d Cong., 1st Sess. 2 (1933).

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[14] *Chapman* v. *Houston Welfare Rights Organization*, 441 U.S. 600, 608 (1979); *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837, 849 (1975); *S.E.C.* v. *C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351-52 n.8 (1943).

[15] Fundamentally implicit in the sale of business doctrine is the proposition that the federal securities laws were enacted to protect passive investors, not entrepreneurs who buy and thereafter control entire businesses. *Landreth Timber Co.* v. *Landreth*, 731 F.2d 1348 (9th Cir. 1984); *Christy* v. *Cambron*, 710 F.2d 669 (10th Cir. 1983); *King* v. *Winkler*, 673 F.2d 342 (11th Cir. 1982); *Sutter* v. *Groen*, 687 F.2d 197 (7th Cir. 1982); *see also*, Easley, *Recent Developments in the Sale of Business Doctrine*, 39 Bus. Law. 929 (1984); Seldin, *When Stock is Not a Security: The "Sale of Business" Doctrine Under the Federal Securities Laws*, 37 Bus. Law. 637 (1982); Thompson, *The Shrinking Definition of a Security: Why Purchasing All of a Company's Stock is Not a Federal Securities Transaction*, 57 N.Y.U. L.Rev. 225 (1982); McAneny, *Acquisition of Businesses Through Purchase of Corporate Stock: An Argument for Exclusion From Federal Securities Regulation*, 8 Fla. St. U.L. Rev. 295 (1980).

Nowhere in the legislative history is there mention of entrepreneurs. The statement of Congressman Sam Rayburn, Chairman of the House Committee on Interstate and Foreign Commerce and one of the principal sponsors of the 1933 Act, reflects the concerns of Congress:

> We have, on the one hand, 18,000,000 *passive citizens* having no actual contact with their companies; on the other hand, a few hundred *powerful managers directing and controlling the destinies of the companies and the physical properties which they own.* The owners of these symbols are entitled to know what the symbols represent. Those who are interested in purchasing these pieces of paper have the right to demand information as to the actual condition of the issuing company. Up to this time such information has depended on the grace of an entrenched management. These managers are truly trustees.

77 Cong. Rec. 2910, 2918 (1933) (emphasis added).

Congressman Rayburn stressed that the purpose of the 1933 Act was to protect those who are not in a position to actually manage the property represented by the instrument they acquire, and who are unable to meaningfully control the success or failure of the venture:

> Today the owner does not possess actual physical properties but he holds a piece of paper which represents certain rights and expectations.... [T]he owners of these pieces of paper have little control over the physical property [and] carry no actual responsibility with respect to the enterprise or its physical property.... [T]he wealth of a particular person is coming more and more to depend on forces beyond his own reach and control.

Id. at 2917.

The purpose of the 1934 Act is equally clear in its protection of passive investors. The House Committee on Interstate and Foreign Commerce, in its report regarding the

1934 Act, observed that the impetus for the legislation was the fact that corporate "[o]wnership and control are in most cases largely divorced." H.R. Rep. No. 1383, 73d Cong., 2d Sess. 3 (1934). The Act was not directed to situations where management and ownership are united, in which a common enterprise does not exist:

> When corporations were small, when their managers were intimately acquainted with their owners and when the interests of management and ownership were substantially identical, conditions did not require the regulation of security [markets].

Id. at 5. This Congressional concern to protect investors who provide venture capital to be used by promoters and managers of businesses is pervasive throughout the legislative history of the 1934 Act. *See* S. Rep. No. 792, 73d Cong., 2d Sess. 4-7, 11-12, 18 (1934).

A corporate entity, such as LTC II, which purchases an entire business and thereafter controls its fortunes, is an entrepreneur, not a passive investor. The seller of a business, such as the Landreths, who retains no control over the enterprise does not serve as a trustee of the purchaser's investment, and thus there is no "common enterprise" after the sale. The difference between an investor who lacks control over the outcome of his investment, and a purchaser of an entire business who has complete entrepreneurial control, is the foundation of the sale of business doctrine. It is a distinction well recognized by both Congress and the prior decisions of this Court.

C. In All of Its Decisions Defining a "Security," This Court Consistently Has Analyzed the Economic Realities Underlying A Transaction.

The following section discusses, in chronological order, this Court's decisions defining a "security." This analysis demonstrates that in determining whether a particular

transaction involves a "security," the Court consistently has looked beyond the instrument itself and has analyzed the economic realities of the underlying transaction. This Court expressly has rejected a literal approach, such as that now urged by LTC II, which would bar inquiry into the economic realities underlying the transaction in which the instrument was transferred. The Court has developed a coherent test for determining whether there is a "security transaction" within the meaning of the Acts: whether it involves an investment in a common enterprise premised on a reasonable expectation of profits to be derived from the managerial or entrepreneurial efforts of others. This analysis applies regardless of the type of instrument involved.

1. *S.E.C.* v. *C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943).

In *Joiner,* the Court considered whether assignments of interests in oil leases, offered by mail to over 1,000 prospective investors and conditioned upon the promoter's promise to drill exploratory wells, constituted "sales of securities" within the meaning of the 1933 Act. In analyzing the definition of the term "security,"[16] the Court applied the doctrine that

> [C]ourts will construe the details of an act in conformity with its dominating general purpose, will read text in the light of context and will interpret the text so far as the meaning of the words fairly permit so as to carry out in particular cases the generally expressed legislative policy.

320 U.S. at 350-51.

The Court recognized that Congress defined the term "security" to include "by name or description many documents in which there is common trading for speculation or investment." 320 U.S. at 351. The Court ruled that the relevant inquiry for determining whether a transaction falls within the terms of the 1933 Act is:

[16] Section 2(1) of the 1933 Act, 15 U.S.C. § 77b(1).

> [W]hat character the instrument is given in commerce *by the terms of the offer, the plan of distribution, and the economic inducements* held out to the prospect.

320 U.S. at 352-53 (emphasis added). Rejecting an "inflexible rule barring inquiry into the economic realities underlying a transaction,"[17] the Court concluded, on the basis of proof "outside the instrument itself" that the context of the transaction brought the instrument within the terms of the 1933 Act. 320 U.S. at 355.

2. *S.E.C.* v. *W.J. Howey Co.*, 328 U.S. 293 (1946).

In *Howey,* the Court considered whether an offering of sales contracts on units in a citrus grove development, coupled with service contracts giving the promoter full discretion and authority to cultivate the groves, market the produce, and allocate and distribute profits, constituted an investment contract and hence a "security" within the 1933 Act. Endorsing an analysis which favors substance over form and focuses on the economic realities underlying the transaction, the Court ruled that the test is "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." 328 U.S. at 301.

The Court stated that its three-part test is consistent with the statutory aims of the Act and that it

> [E]mbodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.

328 U.S. at 299. The Court applied the test to the underlying sales transaction and concluded that all of the elements of a "profit seeking business venture" were present:

[17] *United Housing Foundation, Inc.* v. *Forman,* 421 U.S. 837, 850 (1975) (interpreting its ruling in *S.E.C.* v. *C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943)).

> The investors provide the capital and share in the earnings and profits; the promoters manage, control and operate the enterprise.

328 U.S. at 300.

3. *Tcherepnin* v. *Knight*, 389 U.S. 332 (1967).

In *Tcherepnin*, the Court considered whether withdrawable capital shares in a state savings and loan association constituted a "security" within the meaning of § 3(a)(10) of the 1934 Act. The Court acknowledged that the definition of "security" in the 1934 Act was virtually identical to the definition of "security" in section 2(l) of the 1933 Act. The Court ruled that:

> [I]n searching for the meaning and scope of the word "security" in the Act, *form should be disregarded for substance and the emphasis should be on economic reality.*

389 U.S. at 336 (citing *Howey*, 328 U.S. at 298) (emphasis added).

Substituting the word "security" for "it"[18] in a key quote from *Howey*, the *Tcherepnin* Court stated that the term "security," as used in the Acts, describes "various schemes devised by those who seek the use of the money of others on the promise of profits." 389 U.S. at 338 (quoting *Howey*, 328 U.S. at 299). Acknowledging that the withdrawable shares in the underlying transaction had all the attributes of three of the instruments enumerated in the 1934 Act — investment contracts, certificates of interest, and stock — the Court analyzed the investment scheme under the *Howey* test and determined that the investors were

> [P]articipants in a common enterprise — a money-lending operation dependent for its success upon the skill and efforts of the management of [the savings and loan] in making sound loans.

389 U.S. at 338.

[18] The word "it" as used in the quote from *Howey* refers to the definition of an "investment contract."

4. *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837 (1975).

In *Forman*, the Court considered whether the sale of stock entitling a purchaser to occupy an apartment in a state-subsidized housing co-operative was a sale of a "security" within the meaning of the Acts. The district court had ruled that denominating the instruments as "stock," by itself, did not make the stock a "security." The district court also concluded that the purchase of the stock was not a "security transaction" because it was not induced by the purchasers' expectation of profits. 421 U.S. at 845. The Second Circuit had reversed the district court's decision on two alternative grounds: (1) the Acts were literally applicable because "stock" was one of the specifically enumerated documents in the statutory definition of "security"; and (2) the transaction was an "investment contact" under the *Howey* criteria because profits were expected from the efforts of others.

Ruling that the transactions were not "purchases of securities" within the contemplation of the Acts, this Court reversed the court of appeals' decision. 421 U.S. at 847. The Court divided its opinion into two parts, addressing separately each of the bases upon which the Second Circuit had ruled.

Part A of the opinion addresses the circuit court's literal application of the Acts. The Court recognized that Congress defined the term "security" only in terms of instruments which commonly fell within the ordinary concept of a security, and that it did not set forth the pertinent economic criteria for distinguishing "securities" from non-securities. 421 U.S. at 847. The Court ruled that the task of determining which "of the myriad financial transactions in our society" constitute "transactions in securities" ultimately falls to the federal courts. 421 U.S. at 847-48.

The Court unequivocally rejected the "literal approach" adopted by the Second Circuit that a transaction evidenced by the sale of "stock" is a security transaction simply because

"stock" is one of the specifically enumerated instruments in the statutory definition of a "security." 421 U.S. at 848. Instead, the Court adhered to a substantive analysis of the economic realities underlying the transaction which, in the Court's words, has guided "*all* of [its] decisions defining a security." 421 U.S. at 852 (quoting *Tcherepnin*, 389 U.S. at 336) (emphasis added).

The Court considered the purpose and focus of the Acts and determined that Congress intended coverage of the Acts to turn on the economic realities underlying the transaction and not on the name appended to the instrument:

> Because securities transactions are economic in character *Congress intended the application of these statutes to turn on the economic realities underlying a transaction and not on the name appended thereto.*

421 U.S. at 849 (emphasis added).

The Court recognized that an instrument could fall within the "letter of the statute" and yet not be covered by the Acts because in its commercial context the instrument was not within the statute's spirit or intent. 421 U.S. at 849. The Court expressly rejected the position that its dicta in *Joiner* supported a " 'literal approach' to defining a security." 421 U.S. at 849. Underscoring the conditional tense of its language in *Joiner*, the *Forman* court stated:

> Respondents' reliance on Joiner (sic) as support for a "literal approach" to defining a security is misplaced . . . . In dictum the *[Joiner]* Court noted that "[i]nstruments *may* be included within [the definition of a security], as [a] matter of law, if on their face they answer to the name or description." . . . And later, again in dictum, the [*Joiner*] Court stated that a security "*might*" be shown "by proving the document itself, which on its face would be a note, a bond, or a share of stock." . . . By using the conditional words "may" and "might" in these dicta the Court made clear that it was not establishing an inflexible rule barring inquiry into the economic realities underlying a transaction.

421 U.S. at 850 (citations omitted) (emphasis in original).

In concluding Part A of its opinion, the Court held that the "name" of an instrument, although not "wholly irrelevant," is not dispositive in determining whether the instrument is involved in a "security transaction":

> In holding that the name given to an instrument is not dispositive, we do not suggest the name is wholly irrelevant to the decision whether it is a security. There may be occasions when the use of a traditional name such as "stocks" or "bonds" will lead a purchaser justifiably to assume that the federal securities laws apply. This would clearly be the case when the *underlying transaction* embodies some of the significant characteristics typically associated with the named instrument.

421 U.S. at 850-51 (emphasis added).

In Part B of the *Forman* decision, the Court addressed the question of whether the shares of stock were "investment contracts" or "instruments commonly known as a 'security'." The Court stated that, for purposes of analyzing a transaction to determine if it involves a "security," the Court does not distinguish between investment contracts and other instruments commonly known as securities:

> In considering these claims we *again* must examine the substance — the economic realities of the transaction — rather than the names that may have been employed by the parties.

421 U.S. at 851-52 (emphasis added). The Court recognized that *Howey* set forth the basic test for determining whether a particular transaction is a "transaction in securities," regardless of the name of the instrument involved:

> In either case, the basic test for distinguishing the transaction from other commercial dealings is
>
> > "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."

421 U.S. at 852 (quoting *Howey*, 328 U.S. at 301).

The Court's language left no doubt that the economic criteria enunciated in *Howey* are applicable to all transactions in which the existence of a security is in issue:

> [The *Howey*] test in shorthand form, embodies the essential attributes that run through *all* of the Court's decisions defining a security. The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.

421 U.S. at 852 (emphasis added).

The Court also stated that the essential elements which distinguish a transaction in securities from other commercial dealings are absent in a situation where a purchaser acquires an asset for the purpose of using, developing, or managing it himself. 421 U.S. at 852-53. The Court ruled that:

> "[W]hat distinguishes a security transaction — and what is absent here — is an investment where one parts with his money in the hopes of receiving profits from the efforts of others."

421 U.S. at 858.

The Court's holding that "we decide only that the *type of transaction* before us . . . is not within the scope of the federal securities laws" reinforces the principle that the relevant focus is on the underlying transaction, not on the instrument used. 421 U.S. at 859 (emphasis added).

5. *International Brotherhood of Teamsters* v. *Daniel*, 439 U.S. 551 (1979).

In *Daniel*, the Court considered whether a non-contributory, compulsory pension plan was a "security" within the meaning of the Acts. The pension plan was established by a collective bargaining agreement and could not be waived by employees. It required the employer to make fixed weekly contributions based on the number of eligible employees.

The Court analyzed the economic realities underlying the transaction, acknowledging again that the *Howey* criteria not only determine the presence of an investment contract but also "embod[y] the essential attributes that run through all of the Court's decisions defining a security." 439 U.S. at 558 n.11 (citing *Forman*, 421 U.S. at 852). The Court also noted that the *Howey* test would be equally applicable if the pension plan had all of the attributes of a certificate of interest or a participation in a profit sharing agreement, which, like the stock in this case, are specifically enumerated instruments in the statutory definition of "security." 439 U.S. at 558 n.11.

Evaluating the "economic realities" of the underlying transaction, the Court concluded that the pension plan was not a security because: (1) employees did not make "investments," but rather "sold" their labor to obtain a livelihood; and (2) profits were derived primarily from the efforts of employees, the "investors" in the enterprise, rather than from the success of the investment fund. 439 U.S. at 562.

The Court concluded that an extension of the Acts to the pension plan in dispute was not merited by the language or history of the statute. The Court also noted that no "general purpose" would be served by extending coverage to the disputed plan because adequate protection and alternative remedies were available under other legislation governing employee pension plans. 439 U.S. at 569-70.

6. *Marine Bank* v. *Weaver*, 455 U.S. 551 (1982).

The Court's unanimous decision in *Marine Bank*, removes any doubt about the applicability of the economic realities test to all transactions in which the existence of a security is in question. *Marine Bank* considered whether two instruments, a conventional certificate of deposit and a privately negotiated profit-sharing agreement, constituted a "security." Both of the instruments, like the stock in this case, are specifically listed in the statutory definition of "security."

The Court reconfirmed at the outset that it has "repeatedly held" that the test for whether an instrument is covered under the Acts focuses on the transaction in which the instrument is involved and not on the instrument itself:

> [The test] is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect.

455 U.S. at 556 (quoting *Joiner,* 320 U.S. at 352-53).

The *Marine Bank* court specifically addressed the meaning of the phrase "unless the context otherwise requires," which precedes the statutory definition of the term "security." 455 U.S. at 556. The Court stated that the "context clause" means that "an instrument which seems to fall within the broad sweep of the Act is not to be considered a security if the context otherwise requires." 455 U.S. at 556. *See* Section III.A., *supra.*

In the second half of the *Marine Bank* decision, the Court considered whether a privately negotiated agreement between two parties to share profits from one party's business was a "security." Evaluating the economic realities underlying the agreement, the Court focused on the fact that the agreement was the product of a private rather than a public transaction. Ruling that "a security is an instrument in which there is 'common trading'," the Court concluded that the agreement did not fall within the concept of a "security" because no prospectus was distributed to other potential investors; the terms of the agreement were unique and privately negotiated; and the agreement was not designed to be traded publicly. 455 U.S. at 560 (citing *Joiner,* 320 U.S. at 351). The Court also noted that a provision in the agreement which allowed the non-owners to veto future loans to the owner "gave them a measure of control over the operation of the [business] not characteristic of a security." 455 U.S. at 560. The Court concluded that this "unique agreement, negotiated one-on-one by the parties, is not a security." 455 U.S. at 560.

Finally, in its closing language in *Marine Bank*, the Court unequivocally endorsed its longstanding rule that all disputed instruments must be analyzed in terms of the transaction in which they are involved:

> Each transaction must be analyzed and evaluated on the basis of the content of the instruments in question, the purposes intended to be served, and the factual setting as a whole.

455 U.S. at 560 n.11.

D. An Analysis of the Economic Realities Underlying This Transaction Demonstrates That the Sale of 100% of the Stock of LTC I Was Not a Transaction in Securities.

As recognized by this Court in *Forman,* the *Howey* test embodies the essential attributes of a "security":

> [A]n investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.

421 U.S. at 852 (quoting *Howey,* 328 U.S. at 301).

An analysis of the economic realities underlying this transaction demonstrates that the Landreths' sale of 100% of the stock in LTC I to B&D, a corporate purchaser, was not the sale of a "security" because: (1) there was no "common enterprise" between the purchaser and the Landreths; and (2) the purchaser did not expect profits to be derived from the managerial or entrepreneurial efforts of others.

1. The Sale of 100% of the Stock of LTC I Is Not a Transaction in Securities Because There Is No Common Enterprise Among the Purchaser and the Sellers.

A "common enterprise" is "one in which the fortunes of the investor are interwoven with and dependent upon the

efforts and success of those seeking the investment or of third parties." *S.E.C.* v. *Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482 n.7 (9th Cir. 1973). Circuit courts disagree regarding the extent to which an investor's fortunes must be interwoven with the success of a promoter in order to constitute a "common enterprise." Some courts require a "sharing or pooling of funds" between the investor and the promoter. *See, e.g., Frederiksen* v. *Poloway*, 637 F.2d 1147, 1152 (7th Cir. 1981); *see also Hirk* v. *Agri-Research Council, Inc.*, 561 F.2d 96, 100-01 (7th Cir. 1977). Other courts require only the existence of a relationship between an investor and a broker upon whose expertise the profitability of the investment depends. *See, e.g., S.E.C.* v. *Continental Commodities Corp.*, 497 F.2d 516, 522 (5th Cir. 1974). The Ninth Circuit requires correlation between the success of the promoter and that of the investors' accounts. *See, e.g., Meyer* v. *Thomason & McKinnon Auchincloss Kohlmeyer, Inc.*, 686 F.2d 818 (9th Cir. 1982).

This Court has not yet addressed the issue of the extent to which a "common enterprise" requires that the investors' fortunes be tied to those of the promoter. *See Mordaunt* v. *Incomco*, No. 83-225, slip op. at 3 (U.S. Jan. 7, 1985). Regardless of which view this Court ultimately adopts, however, there is no common enterprise between the purchaser and the seller in the sale of a business through the transfer of 100% of the corporation's stock, because at the time of closing the transfer of ownership is complete and the fortunes of the purchaser subsequently are not interwoven with, or dependent upon, the efforts or success of the seller. *See S.E.C.* v. *Glenn W. Turner Enterprises, Inc.*, 474 F.2d at 482 n.7.

Although the lower courts in this case did not address the issue of whether B&D invested in a "common enterprise"

with the Landreths,[19] at least two other courts of appeals decisions have ruled, under virtually identical facts, that the sale of 100% of the stock of a closely held corporation fails to satisfy the common enterprise element of the "economic realities" test. *See Canfield* v. *Rapp & Son, Inc.*, 654 F.2d 459, 464 (7th Cir. 1981); *Frederiksen*, 637 F.2d at 1152.

The total absence of a "common enterprise" in the sale of a business to a single corporate purchaser through the transfer of 100% of the corporation's stock is the key factor which distinguishes it from stock sales of less than 100%. In transactions where less than the entire ownership interest is conveyed, there could be a "common enterprise" between the purchaser and the seller or other third parties, depending upon the circumstances of the transaction and the degree to which the purchaser's fortunes are intertwined with the success of the seller or others in the business venture. If a "common enterprise" is found to exist, a court then would have to address the other elements of the "economic realities" test, and decide whether the purchaser reasonably expected profits in reliance upon the managerial or entrepreneurial efforts of others. *See* Section III.D.2, *infra*.

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[19] Although counsel for the Landreths asserted in pleadings filed with the district court in support of their motion for summary judgment that there was no common enterprise among the Landreths and the purchaser, in applying the "economic realities" test to B&D's purchase of 100% of the stock of LTC I from the Landreths, the district court ruled:

> [T]his Court need only determine whether the third requirement has been met, whether the purchasers were led to expect profits from the managerial or entrepreneurial efforts of others.

Appendix B at A-10. The Ninth Circuit focused solely on the third element of the "economic realities" test:

> The application of the *Howey* test to the acquisition of a business through purchase of a stock is straightforward: When a person purchases control of a business, he does not make an investment from which he expects profits solely from the efforts of others.

Landreth Timber Co. v. *Landreth*, 731 F.2d 1348, 1352 (9th Cir. 1984).

However. in analyzing whether the sale of 100% of the stock of a closely held corporation to a single purchaser constitutes a "transaction in securities," it is unnecessary for the Court to inquire whether the purchaser intended to manage or control the business because the first requirement of the "economic realities" test, a "common enterprise," has not been met. The fact that a purchaser does not invest in a "common enterprise" with the seller in and of itself removes the transaction from the scope of the federal securities laws. Only if a transaction involves a "common enterprise" is it necessary to reach the next level of inquiry and determine who, among the persons or entities engaged in the common enterprise, manages or controls the investment.

The absence of a "common enterprise" in this transaction presents this Court with an issue of first impression[20] and goes to the heart of why this transaction is not a "transaction in securities." Because there is no common enterprise or pooling of funds in the sale of 100% of a corporation's stock, the transaction falls outside the intent and purpose of the Acts.

2. *The Sale of 100% of the Stock of LTC I Is Not a Transaction in Securities Because The Purchaser Did Not Have an Expectation of Profits to Be Derived From the Entrepreneurial or Managerial Efforts of Others.*

The legislative history of the Acts exhibits a Congressional intent to protect those investors who provide venture capital to promoters but remain dependent

[20] The transaction at issue herein presents this Court with the first case in which the common enterprise element of the economic realities test has not been met. All of the Court's prior decisions defining a "security" have involved transactions in which the existence of a "common enterprise" was neither disputed by the parties nor specifically addressed by the Court.

upon others for the management and outcome of their investment. *See* Section III.B, *supra.* This aspect of the economic realities test has been carefully developed in the precedential analysis of this Court. *See* Section III.C, *supra.* It is a critical aspect of the economic realities test that the investment be "premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others." *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837, 852 (1975). When a purchaser acquires complete ownership of a business through the purchase of 100% of a corporation's stock, such purchaser has an unfettered right to manage and control the business. Thus, in adopting the sale of business doctrine, a number of courts have held that acquisition of an entire business through the purchase of its stock does not constitute a "security" under the Acts.[21]

The requirement of the Acts that a purchaser rely on the efforts of others for his profits has been repeatedly emphasized by this Court. In *S.E.C.* v. *W.J. Howey Co.*, 328 U.S. 293 (1946), the Court noted that the promoter's management, control and operation of the enterprise was a significant element of a "profit-seeking business venture." 382 U.S. at 300.

In *Tcherepnin* v. *Knight*, 389 U.S. 332, 345 (1967), the Court emphasized that investors in a savings and loan association required the protection of the Acts because they "had to rely completely on City Savings' management to choose suitable properties on which to make mortgage loans . . ." *citing Tcherepnin* v. *Knight*, 371 F.2d 374, 384 (7th Cir. 1967).

In *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837, 852-53 (1975), the Court found that when a purchaser is motivated by a desire to use or consume the asset purchased, i.e., when the subject of the purchase is within the buyer's own control, the Acts do not apply.

[21] See n. 15, *supra.*

Similarly, in *International Brotherhood of Teamsters* v. *Daniel*, 439 U.S. 551, 561-62 (1979), the Court concluded that a compulsory, non-contributory pension plan was not a security because the majority of income in the plan was the result of employer contributions, a source which was not dependent upon the efforts of the fund's managers. Thus, the employees were not investors who were relying to any substantial degree on the efforts of others for an expectation of profits.

Finally, in *Marine Bank*, 455 U.S. at 551, 560 (1982), this Court decided that the transaction did not involve a security because a privately negotiated profit-sharing agreement gave the investors a right to use some of the facilities of the business and the authority to veto loans. Thus, the investors had "a measure of control over the operation of the [business] not characteristic of a security." *Id.*

In the case now before the Court, LTC II obtained and exercised complete corporate control over the business which it acquired from the Landreths. In its admissions of fact before the district court, LTC II conceded that it acquired 100% of the stock of LTC I at closing, and that none of the Landreths became officers, directors, shareholders or employees of the purchasing entity (J.A. 182, 184, 204). Pursuant to the Stock Purchase Agreement, the Landreths resigned as officers and directors of LTC I, and had no right to share in the profits or losses of LTC II (J.A. 186, 204). Prior to closing of the sale, the purchaser selected and retained its own mill manager who assumed this position immediately upon closing (J.A. 186-188). After the sale of the business, Ivan Landreth's role was limited to that of a consultant who was terminable at will. Within two months after the date of sale, LTC II terminated Landreth (J.A. 189-90, 201, 309).

LTC II suggests in its brief that Landreth and Cook, LTC II's own mill manager, are "others" with whom the purchaser invested in a common enterprise and from whose efforts it expected profits. *See, e.g.*, Pet. Br. at 8-9, 42. The admitted

facts establish, however, that Landreth had no control over the business after closing of the sale (J.A. 191-98). Moreover, both Landreth[22] and Cook remained under the ultimate control of the purchaser. Within the context of a securities transaction, the term "others" means persons or entities beyond the control of the purchaser. *Bitter* v. *Hoby's International, Inc.*, 498 F.2d 183, 186 (9th Cir. 1974). Employees or consultants retained by the purchaser are not beyond the purchaser's control and, therefore, are not "others" within the meaning of the economic realities test. As the *Bitter* court stated:

> For the manager to be a "third party," within the meaning of the [economic realities] test, the manager must be outside of the direct and immediate control of the franchisee.

498 F.2d at 186. *See Landreth Timber Co.* v. *Landreth*, 731 F.2d 1348, 1353 (9th Cir. 1982); *see also Frederiksen*, 637 F.2d at 1152 (rejecting purchaser's argument that seller's continued employment as "consultant," including right to receive commissions and a share in profits, constituted a "sharing or pooling of funds").

In summary, for many of the same reasons that there was no "common enterprise" among sellers and purchaser in this transaction, there also was no purchaser reliance upon an expectation of profits to be derived from the entrepreneurial or managerial efforts of "others." As the Ninth Circuit correctly stated:

> Following the transaction, Landreth II had full control of the corporation, including the day-to-day operations of the mill and its employees. In "economic reality," the underlying transaction was a sale of a

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[22] Landreth was retained as a consultant for only two months after closing. His functions and ability to affect the business were negligible and were totally within the control and discretion of the purchaser (J.A. 188, 191-98).

lumber business and, under the sale-of-business doctrine, was not an investment in a "security."[23]

Landreth Timber Co. v. *Landreth*, 731 F.2d at 1353.

E. Policy Considerations Favor the Continued Application of the Economic Realities Test in Determining Whether a Transaction Constitutes a Security Within the Scope of the Acts.

1. Consistency in Application of the Securities Laws Requires Continued Adherence to the Economic Realities Test.

In a series of decisions spanning the past forty-two years, this Court consistently has analyzed the economic realities of the underlying transaction in determining whether a transaction involved a "security" subject to the Acts. *See* Section III.C., *supra*. In these decisions the Court has had no difficulty in applying the economic criteria of *Howey* and *Forman* to transactions involving a variety of specifically enumerated instruments under the Acts.

It is against this precedential background that the Court must analyze LTC II's argument that the economic realities test should be discarded, and a "traditional characteristics" test should be applied, in order to determine whether the sale of all of the stock of a business is a transaction in securities.

The "traditional characteristics" test, as advocated by LTC II, has *never* been applied by this Court. This Court only has noted that the existence of traditional characteristics of an enumerated instrument under the Acts "*may*" or "*might*" be helpful in making a determination regarding the existence of a transaction in securities. *United Housing*

[23] The court further stated that the "uncontested facts belie" the assertion that purchaser was somehow dependent on Ivan Landreth. The court emphasized that LTC II had hired its own mill manager who assumed effective control of the business and that Landreth's services as a consultant were terminable at the will of LTC II. The court concluded that neither Landreth nor LTC II's manager could be regarded as a third-party on whose efforts the purchaser relied for its expectation of profit. 731 F. 2d at 1353.

Foundation, Inc. v. *Forman*, 421 U.S. 837, 850 (1975). Nevertheless, in each of its decisions the Court has decided to employ a transactional analysis in determining the existence of a security. *See* Section III.C., *supra*.

Given the Court's endorsement of the economic realities test in a variety of transactional contexts, the application of LTC II's proposed "traditional characteristics" test would create the anomaly of applying a variety of conflicting standards to the various instruments listed under the Acts. If the Court adopts the literal approach proposed by LTC II and the S.E.C. for determining whether "stock" is a security, it inevitably will be required to create a variety of specialized tests for the instruments enumerated in the Acts, including the following:

(1) A "traditional characteristics" test which would be applied to certain "typical" instruments, including stock[24] and other undetermined instruments. This test would focus on the form of the instrument irrespective of its transactional context.

(2) The economic realities test of *Howey* and *Forman* which, according to LTC II, would apply to an analysis of certain "atypical" instruments and investment contracts;[25]

(3) An "overriding federal regulation" test which would disregard the first two tests, excluding certificates of

[24] Contrary to LTC II's assertion, the "stock" at issue here did not possess all of the traditional characteristics ordinarily associated with stock under the Acts. LTC I was a closely held family business, and thus the negotiability of the shares was limited. There were no regular meetings, and no dividends were declared (R. 70 at 2). Furthermore, the stock on transfer to B&D, lacked what this Court has deemed to be the "most common feature of stock: the right to receive 'dividends contingent upon an apportionment of profits.' " *Forman*, 421 U.S. at 851 (citing *Tcherepnin*, 389 U.S. at 339). LTC II's profits were "contingent" only upon the success or failure of its own managerial efforts. Thus, even under LTC II's formulation of the traditional characteristics test, the stock at issue was "atypical," requiring a review of the economic realities underlying the transaction.

[25] Note that LTC II cannot attack the viability of the economic realities test given its repeated application by this Court. LTC II can only attempt to restrict its application, arguing that such test applies only to investment contracts or "atypical" instruments. Pet. Br. at 27.

deposit and perhaps other instruments from the application of the Acts, presumably based upon the intensity and extent of federal regulation over such instruments. *See* the S.E.C.'s labored attempts to distinguish *Marine Bank* v. *Weaver*, 455 U.S. 551 (1982). S.E.C. Br. at 19-20; and

(4) Various other tests, which presumably would have to be created and applied to instruments depending upon their innate characteristics or the circumstances of their use.[26]

The creation of such diverse tests would conflict with this Court's expressed affirmation that certain common essential attributes run through *all* of its decisions defining a security. *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837, 852 (1975).

Moreover, the definitional sections of the Acts do not readily submit to application of the proposed "traditional characteristics" test. Many instruments which appear on their face to be instruments listed in the Acts are not securities. For example, the term "note" is included within the statutory definition of a "security," and yet it would be preposterous to suggest that every document which has all of the traditional characteristics of a "note" necessarily constitutes a "security".[27]

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[26] *See Ruefenacht* v. *O'Halloran*, 737 F.2d 320, 324-25 (3d Cir. 1984) in which the Third Circuit, in rejecting the sale of business doctrine, implicitly recognized the resulting need for different analyses in order to determine whether instruments entitled "stock," "notes" and "commercial paper" constituted a "security" under the Acts.

[27] Courts routinely refer to economic realities in determining whether a "note" is to be considered a "security." *See, e.g., Chemical Bank* v. *Arthur Anderson & Co.*, 726 F.2d 930 (2d Cir. 1984); *National Bank of Commerce* v. *All American Assurance Co.*, 583 F.2d 1295 (5th Cir. 1978); *Exchange National Bank* v. *Touche Ross & Co.*, 544 F.2d 1126 (2d Cir. 1976); *Emisco Industries, Inc.* v. *Pro's Inc.*, 543 F.2d 38 (7th Cir. 1976); *Great Western Bank & Trust* v. *Kotz*, 532 F.2d 1252 (9th Cir. 1976); *McClure* v. *First National Bank of Lubbock*, 497 F.2d 490 (5th Cir. 1974); *Bellah* v. *First Nat'l Bank of Hereford*, 495 F.2d 1109 (5th Cir. 1974); *Lino* v. *City Investing Co.*, 487 F.2d 689 (3d Cir. 1973).

The "traditional characteristics" test, by proposing that the Court focus entirely on the form of the instrument in determining the existence of a security, disregards the intent of the Acts which were designed to protect investors of venture capital who become involved in enterprises managed by others, leaving such investors with little or no control over the outcome of their investment. *See* Section III.B., *supra*. The proposed "traditional characteristics" test ignores the repeated focus of this Court on the economic realities of the underlying transaction in order to determine whether it includes a security within the purpose and intent of the Acts.

2. The S.E.C.'s Positions Regarding the Existence of a "Security" Under the Acts Are Inconsistent And Have Been Rejected by This Court.

It is interesting to note that approximately 38 years ago, the S.E.C. argued in favor of the position which now forms part of the basis of the economic realities test. In *S.E.C.* v. *W.J. Howey Co.*, 328 U.S. 293 (1946), the S.E.C. contended:

> [T]hat the ruling of the Circuit Court of Appeals [affirming a denial of the S.E.C.'s attempt to enjoin a scheme as a violation of the 1933 Act] conflicted with other federal and state decisions and that it introduced a novel and unwarranted test under the statute which the Commission regarded as administratively impractical.

328 U.S. at 294.

In *International Brotherhood of Teamsters* v. *Daniel*, 439 U.S. 551 (1979), the Court stated that it was not the S.E.C.'s role to determine the extent of federal jurisdiction:

> Although these limits [of how far an agency may go in interpreting a statute] are not always easy to discern, it is clear here that the SEC's position is neither long-standing nor even arguably within the outer limits of its authority to interpret these Acts.

439 U.S. at 566 (footnote omitted). The Court stressed that on a number of prior occasions it had been necessary to reject the S.E.C.'s interpretation of various provisions of the Acts. 439 U.S. at 566 nn.20-22.

While campaigning in lower courts for a traditional characteristics approach to defining "securities" in sale of business cases, the S.E.C., as *amicus*, took the opposite position in *Marine Bank*, supporting an approach which ultimately excluded certain certificates of deposit from the coverage of the Acts based upon the transactional context.[28] 455 U.S. at 557. Moreover, in a case currently under review by the Second Circuit involving the question of whether "notes" are securities under the Acts, the S.E.C. again apparently has endorsed a "transactional context" approach. *S.E.C.* v. *American Board of Trade*, 16 Sec. Reg. & L. Rep. (BNA) 1921-22 (Dec. 7, 1984).

In summary, given the S.E.C.'s historic inconsistency in interpreting the Acts,[29] and the inherent limitations on the scope of its interpretative powers, the federal courts, not the S.E.C., are the appropriate forum for a determination of the applicability of the Acts to the sale of a business.

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[28] The S.E.C.'s *amicus* brief in *Marine Bank* v. *Weaver* conceded, among other things, that the analysis of the economic context required by the securities laws included "the surrounding factual circumstances," and recognized that the Acts were designed to help investors, not entrepreneurs such as the plaintiff in *Marine Bank*. S.E.C. brief in *Marine Bank* v. *Weaver* at 8, 18.

[29] The S.E.C.'s position also has been inconsistent within given types of instruments. In *Marine Bank* v. *Weaver*, 455 U.S. 551 (1982) the Court noted that the S.E.C. had taken the position in other proceedings that certificates of deposit constituted securities. The S.E.C. brief in *Marine Bank*, however, urged the opposite position, arguing that the Weavers' certificate of deposit was not a security. 455 U.S. at 557 n.6.

3. The "Sale of Business Doctrine" Reduces, Rather Than Expands, the Burden on the Federal Judiciary.

a. Congress Did Not Intend the Acts To Provide a Remedy for All Types of Alleged Fraud and Misrepresentation.

There is no identifiable federal interest in applying the Acts to instances of alleged fraud and misrepresentation where there is neither: (1) a common enterprise between the purchasers and the sellers of a business, nor (2) investors who are dependent upon the efforts of others for their expectation of profits. The Acts reflect a Congressional intent to provide a remedy for investors who, without the ability to control the outcome of their investment, provide venture capital to promoters who control and manage the business. *See* Section III.B., *supra*.

As this Court stated in *Marine Bank:*

> [W]e are satisfied that Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud. *General Western Bank & Trust* v. *Kotz*, 532 F.2d 1252, 1253 (C.A. 9 1976); *Bellah* v. *First National Bank*, 495 F.2d 1109, 1114 (C.A. 5 1974).

455 U.S. at 556.

Investors in commercial transactions outside of the Acts will continue to have a remedy under state law for alleged fraud or misrepresentation.[30] However, it is both unnecessary and improper for the federal judiciary to extend the protection of the Acts to entrepreneurs who purchase all of the stock of a closely held corporation, particularly where the purchase of stock is merely an alternative method of acquiring the assets of the business.

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[30] An entrepreneur who purchases 100% of the stock of a business inherently has considerable leverage to obtain the disclosure of information, warranties, and other contractual protections against fraud. Such an investor also has substantial ability to provide contractual remedies in the event fraud occurs. In this case LTC II negotiated extensive warranties for its own protection and then coerced the Landreths into substantially increasing amounts placed into an escrow fund as a condition of receiving a further installment on the purchase price. (R. 69 at 64-69).

b. Continued Application of the Economic Realities Test Will Properly Limit the Involvement of the Federal Judiciary in Transactions Involving the Sale of an Entire Business: Federal Courts Can Apply the Economic Realities Test in a Fair and Predictable Manner.

LTC II and the S.E.C. both argue that application of the sale of business doctrine will increase the burden on federal courts. They fail to appreciate that the economic realities test is a limitation on, not an expansion of, federal jurisdiction. Consequently it is difficult to conceive how this test would increase the burden on federal courts. On the contrary, rejection of the sale of business doctrine in the *Landreth* case, and an adoption of the proposed "traditional characteristics" test, necessarily would begin a new wave of federal securities litigation, ultimately requiring this Court to decide what instruments are subject to the "traditional characteristics" test; what transactions are subject to the "economic realities" test; what instruments are excluded from either test because of the extent of federal regulation; and what other tests, if any, should apply to other instruments enumerated in the definitional sections of the Acts. Thus, the adoption of the "traditional characteristics" test with respect to "stock" will guarantee a substantial additional period of appellate controversy.

Moreover, application of the economic realities test to the sale of a business allows federal district courts to dispose of a number of cases by way of summary judgment, thereby avoiding lengthy and complex trials. In a summary judgment setting, a federal court is concerned only with deciding whether the criteria of the economic realities test are met, including a determination of whether there has been an investment of money in a common enterprise, with an expectation of profits to come from the efforts of others. In a situation involving the sale of 100% of a corporation's stock, such as the sale of LTC I, there is no "common enterprise," and the issue can be decided as a matter of law. Moreover, where all of the stock of a business is sold to a purchaser who assumes complete control over the outcome of his investment

there is no reliance on the managerial efforts of others and, as a matter of law, dismissal of federal securities claims is equally appropriate. *See Landreth Timber Co.* v. *Landreth*, 731 F.2d 1348, 1353 (9th Cir. 1984).

Even in instances where less than 100% of the stock is acquired by a purchaser, and where a common enterprise may be determined to exist, a district court can hear evidence regarding the extent of the purchaser's control over the business, and thereafter can make a reasoned decision regarding the existence of federal claims without the necessity of a lengthy and complex securities fraud trial. In such a hearing it would be unnecessary to consider evidence of alleged fraud, related causes of action, pendent claims, and damages, all time-consuming elements of a federal securities fraud trial. Application of the sale of business doctrine will prevent an excessive number of cases from being brought in federal court which, in reality, involve the purchase of businesses by entrepreneurs for whom Congress never intended special protection. Thus, the economic realities test remains a workable common sense approach for applying the Acts consistent with their purpose.

IV. CONCLUSION

The decision of the Ninth Circuit Court of Appeals should be affirmed.

DATED this 4th day of February, 1985.

Respectfully submitted,

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APPENDIX A

References to Record

Document Title	Document No. In Record	Page Within Document	Page of Brief
Jack Branch deposition transcript, p. 23, App. B to Affidavit of James A. Smith, Jr., filed September 25, 1980 ("Smith Aff.")	R.69	242	3
Ivan Landreth letter to Gene Graf, App. B to Affidavit of John W. Hathaway, dated November 7, 1980	R.93	157	3
Article from Forbes, App. A to Smith Aff.	R.69	5	3
Dennis deposition transcript, p.3, App. B to Smith Aff.	R.69	141	3
LTC I listing of business, App. B to Affidavit of John W. Hathaway, dated November 7, 1980	R.93	158	3n.6
Affidavit of Ivan K. Landreth ¶ 5, filed September 25, 1980	R.70	2	3n.6
Dennis deposition transcript, p. 50-51, App. B to Smith Aff.	R.69	174-75	3n.7
Branch deposition transcript, p. 28-29, App. B to Smith Aff.	R.69	244-45	3n.7

Document Title	Document No. In Record	Page Within Document	Page of Brief
Dennis deposition transcript, at 97 and 107, App. B to Smith Aff.	R.69	181-82	4
Dennis deposition transcript at 25, 46, 50-51, 53-54, Robert M. Ingram deposition transcript at 83-85, 135-36, App. B to Smith Aff.	R. 69	161, 171 174-75, 179-80, 310-14	4
Appraisal Report, Landreth Timber Company, Inc., App. A to Smith Aff.	R.69	93-122	4
Dennis deposition transcript at 14-20, 422-23, App. B to Smith Aff.	R.69	152-58 228-29	4
Affidavit of Ivan K. Landreth ¶ 8, filed September 25, 1980	R.70	2-3	33
Escrow Agreement and Amended Escrow Agreement, App. A to Smith Aff.	R.69	64-69	37

APPENDIX B

UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF WASHINGTON
AT SEATTLE

No. C78-663R

LANDRETH TIMBER COMPANY, INC.,
Plaintiff,

v.

IVAN K. LANDRETH and LUCILLE LANDRETH, husband and wife; THOMAS E. LANDRETH, IVAN K. LANDRETH, JR., and KATHLEEN LANDRETH, husband and wife,
Defendants.

IVAN K. LANDRETH AND LUCILLE LANDRETH, husband and wife; THOMAS E. LANDRETH; IVAN K. LANDRETH, JR. and KATHLEEN LANDRETH, husband and wife,
Counterclaim Plaintiffs,

v.

LANDRETH TIMBER COMPANY, INC.,
Counterclaim Defendant.

ORDER GRANTING SUMMARY JUDGMENT

THIS MATTER comes before the Court on cross-motions for summary judgment. Oral argument was heard on February 27, 1981. At the conclusion of that hearing, the Court indicated its inclination to grant summary judgment in favor of the defendants and asked counsel to submit a list of admitted facts bearing on the issue of

managerial control. Subsequent to the hearing, counsel submitted admitted facts and supplemental memoranda regarding managerial control. Counsel for the plaintiff also filed a motion for reconsideration. On April 17, 1981, the Court heard argument on the issue of managerial control. Having considered the motions, memoranda, affidavits, admitted facts, and being fully advised, the Court now finds and rules as follows:

This is an action by the plaintiff Landreth Timber Company to recover for violations of the federal securities laws,[1] state securities laws and state common law. The issue presented is whether the sale of 100% of the stock of a closely-held corporation is a transaction covered by the federal securities laws. This Court joins a growing majority in holding that the federal securities laws do not apply.

Summary judgment is proper where there is no genuine issue of material fact or where viewing the evidence and the inferences which may be drawn therefrom in the light most favorable to the adverse party, the movant is clearly entitled to prevail as a matter of law. *Great Western Bank & Trust v. Kotz*, 532 F.2d 1252, 1254 (9th Cir. 1976); *Marx v. Computer Services Corp.*, 507 F.2d 485, 487 (9th Cir. 1974). A factual issue is immaterial if resolution of the issue is not necessary in order for the court to reach its decision. *Cordas v. Speciality Restaurants, Inc.*, 470 F. Supp. 780 (D. Ore. 1979).

The material facts in this case are undisputed. The defendants sold 100% of the stock of the Landreth Timber Company to the plaintiff's predecessor-in-interest. The stock possessed the ordinary characteristics of stock.

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[1] Section 12(1), 12(2), and 17(a) of the Securities Act of 1933, 15 U.S.C. §§ 77l(1), 77l(2) and 77q(a); section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b); Rule 10b-5 of the Securities Exchange Commission, 17 CFR § 250.10b-5.

The two principal financial backers behind the purchase, Samuel S. Dennis and John Bolten Sr., were not knowledgeable in any aspect of the lumber industry.

Prior to closing the transaction, the purchasers retained Phil Cook to be general manager of the mill after closing. On the closing date, November 17, 1977, two agreements were entered into: (1) a stock purchase agreement which transferred 100% of the stock and required the defendants to deliver to the purchasers the signed resignations of all the officers and directors of the Landreth Timber Company, and (2) a consulting agreement between Ivan K. Landreth Sr. and the purchasers. The nature and scope of Landreth's post-closing role as consultant was defined in the consulting agreement as follows:

> 1.2 *Consulting Duties, Etc.* The Company shall employ the consultant (a) to participate in the operation of the timber mill owned by the Company in the first six (6) months of the Consulting Period, and (b) for such purposes as the Company reasonably deems appropriate in the second six (6) months of the Consulting Period; and the consultant shall devote such time and effort and shall perform such services as are appropriate or necessary to the performance of his duties as a consultant to the Company in connection with such participation and for such purposes.

Pursuant to this agreement, Landreth's role was purely advisory; the authority to make any and all managerial decisions was transferred to Phil Cook and, ultimately, to the purchasers. The consulting agreement also provided that Landreth's post-closing employment was terminable by plaintiff at will upon thirty days' prior written notice.

Subsequent to closing the transaction, it allegedly became apparent that numerous misrepresentations had been made by the defendants during the course of nego-

tiations. The plaintiff terminated the consulting agreement with Landreth and filed this action.

The threshold issue in this case is whether the stock involved is a "security." The parties agree that a transaction evidence by the sale of stock is not necessarily a security transaction simply because the statutory definition of a security includes the words "any . . . stock." *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 848 (1974). Rather, the courts adhere to the principle that "in searching for the meaning and scope of the word "security" in the Act[s], form should be disregarded for substance and the emphasis should be on economic reality." *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967).

What, then, are the relevant "economic realities" that must be examined? How closely should a court examine a stock before determining whether it is a "security"? It is here that the parties differ. The plaintiff contends that the Court should constrain itself to examining the characteristics of the stock itself. The plaintiff points out that Landreth stockholders have the following rights: receiving notice of any shareholders' meeting; electing and removing directors and filling vacancies; receiving certificates representing their ownership interest; transferring shares to a third party; receiving declared dividends; amending by-laws; and all rights granted to shareholders by Washington law. The plaintiff argues that these traditional characteristics of stock would lead a reasonable purchaser to assume that the securities laws would apply and, therefore, the Court should look no further.

The defendants, on the other hand, urge the Court to look beyond the characteristics of stock to the economic realities of the underlying transaction. They contend that the transaction at issue was essentially the sale of a business, through the transfer of stock, and that such a transaction is not within the purview of the federal securities laws.

This issue can be resolved only after a careful reading of the Supreme Court's decision in *Forman, supra.* In *Forman*, residents of a cooperative housing project, who had been required to purchase "stock" in the housing cooperative in order to acquire a residential unit, filed an action for fraud under the federal securities laws. The Court held that the shares of stock did not constitute "securities" within the meaning of those laws.

In part "A" of the Forman opinion, the Court rejected the argument that a transaction, evidenced by the sale of shares called "stock," must be considered a security transaction simply because the statutory definition of a security includes the words "any . . . stock." 421 U.S. at 848. In doing so, the Court emphasized the purposes underlying the federal securities laws.

> The focus of the Acts is on the capital market of the enterprise system: the sale of securities to raise capital for profit-making purposes, the exchanges on which securities are traded, and the need for regulation to prevent fraud and to protect the interest of investors. Because securities transactions are economic in character Congress intended the application of these statutes to turn on the economic realities underlying a transaction, and not on the name appended thereto. 421 U.S. at 849.

The Court concluded that the "stock" before it was not a "security" within the meaning of the federal securities laws. In doing so, the Court relied both on the fact that the shares did not possess the characteristics traditionally associated with stock (e.g. no dividends, no right to pledge or hypothecate, no voting rights), and on the fact that the inducement to purchase was solely to acquire subsidized low-cost living space; it was not to invest for profit. 421 U.S. at 851.

In part "B" of the opinion, the Court rejected the Court of Appeals' conclusion that a share in the housing

cooperative was an "investment contract" as defined by the Securities Acts, and rejected the plaintiffs' further argument that in any event what they agreed to purchase is "commonly known as a 'security'" within the meaning of those laws. The Court stated:

> In considering these claims we again must examine the substance—the economic realities of the transaction—rather than the names that may have been employed by the parties. We perceive no distinction, for present purposes, between an "investment contract" and an "instrument commonly known as a 'security'." In either case, the basic test for distinguishing the transaction from other commercial dealings is
>
> > "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." *Howey*, 328 U.S. at 301.
>
> This test, in shorthand form, embodies the essential attributes that run through all of the Court's decisions defining a security. The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others. 421 U.S. at 852.

Three aspects of the above-quoted passage should be noted in particular. First, the Court states that "we *again* must examine the substance—the economic realities of the transaction. . . ." (emphasis added). This is a further indication that the Court in part "A" was looking to the economic realities of the underlying transaction, and not simply examining the characteristcs of the stock instruments themselves. Second, the Court indicates a distinction between security transactions and "other commercial dealings." As the Court states later in the same paragraph, in a securities transaction the investor is attracted solely by the prospect of a return on his investment. 421 U.S. at 852.

> By contrast, when a purchaser is motivated by a desire to use or consume the item purchased—"to occupy the land or develop it themselves" as the *Howey* Court put it, *ibid.*—the securities laws do not apply. 421 U.S. at 852-53.

Finally, it should be noted that the Court states that the *Howey* test "embodies the essential attributes that run through *all* of the Court's decisions *defining a security*." (emphasis added). This is a strong indication that the Court intends that the *Howey* test be generally applicable to all cases where the meaning of "security" is at issue, not just cases involving the definition of "investment contract." This conclusion is further supported later in the *Forman* opinion where the Court states:

> What distinguishes a security transaction—and what is absent here—is an investment where one parts with his money in the hope of receiving profits from the efforts of others. . . . 421 U.S. at 858.

For these reasons, this Court concludes: (1) that it must look beyond the characteristics of the stock itself to the economic realities of the underlying transaction, (2) that it must bear in mind a distinction between security transactions and other commercial dealings, and (3) that the *Howey* test focuses on the relevant "economic realities" and is applicable in determining whether a stock transaction is within the purview of the federal securities laws. These conclusions comport with the majority of post-*Forman* decisions. *Frederiksen v. Poloway*, 637 F.2d 1147 (7th Cir. 1981); *Chandler v. Kew*, Fed Sec. L. Rptr. ¶ 96,966 (10th Cir. 1977); *Bula v. Mansfield*, Fed. Sec. L. Rptr. ¶ 96,964 (D. Col. 1977); *Dueker v. Turner*, Fed. Sec. L. Rptr. ¶ 97,535 (D. Geo. 1979); *Anchor-Darling Industries v. Leonard Suozzo*, No. 79-4085, E.D. Penn, March 16, 1981; *Barsy v. Verin*, No. 79 C 3323, N.D. Ill., February 25, 1981. *But see Coffin v. Polishing Machines, Inc.*, 596 F.2d 1202 (4th Cir. 1979); *Titsch Printing, Inc. v. Hastings*, 456 F. Supp. 445 (D. Col.

1978); *Bronstein v. Bronstein*, 407 F. Supp. 925 (E.D. Penn 1976).

In applying the *Howey* test, this Court need only determine whether the third requirement has been met, whether the purchasers were led to expect profits from the managerial or entrepreneurial efforts of others. This determination must be made based on the factual circumstances at the time of the agreement and not on facts occurring subsequent to the agreement. *El Khadem v. Equity Securities Corp.*, 494 F.2d 1224, 1228 (9th Cir. 1974). It also irrelevant for the purchasers to argue that they relied on Landreth's past efforts to build up the business. As the Seventh Circuit stated in *Emisco Industries v. Pro's Inc.*, 543 F.2d 38 (7th Cir. 1976):

> This only repeats plaintiffs' allegation of reliance upon misrepresentations made during the purchase. The important element for the transaction to constitute an investment is that [the purchaser] relied on the present and future efforts of another to produce profits. 543 F.2d at 41.

Thus, events occurring prior to the agreement are relevant only insofar as they indicate whether the purchasers, as of the date of the agreement, were led to expect profits resulting from the future entrepreneurial or managerial efforts of others.

The purchasers argue that the third requirement of *Howey* has been met because they were led to expect profits from the efforts of Landreth and Cook. In other words, the purchasers argue that Landreth and Cook are "others" for purposes of the third requirements of the *Howey* test.

This argument exalts a literal reading of the *Howey* test over the purposes of the federal securities laws. The fundamental purpose of those laws is to protect those who place their money in the hands of someone over whom they exercise little or no control. Persons or entities who are beyond the control of the purchaser are

"others" within the meaning of *Howey* and *Forman*. Employees, including managers and consultants, are not. *Bitter v. Hoby's International Inc.*, 498 F.2d 183 (9th Cir. 1974). In the words of the Ninth Circuit in *Bitter*:

> For the manager to be a "third party," within the meaning of the *Howey* test, the manager must be outside of the direct and immediate control of the franchise. 498 F.2d at 186.

In the present case, both Landreth and Cook, as employees, were under the direct and immediate control of the purchasers after the sale and, therefore, they are not "others' or "third parties" within the meaning of *Howey* and *Forman*. Because there are no "others" involved in this case, it is not necessary to apply the analysis in *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476 (9th Cir. 1973).[2]

For these reasons, the motion for reconsideration is DENIED and the defendants' motion for summary judgment is GRANTED.

IT IS SO ORDERED.

The Clerk of this Court is directed to send uncertified copies of this Order to all counsel of record.

DATED at Seattle, Washington, this 29th day of April, 1981.

/s/ Barbara J. Rothstein
United States District Judge

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[2] In *Turner*, the promoter/seller was beyond the control of the purchasers and, therefore, it was an "other" or "third party" within the meaning of *Howey*. This made it necessary to analyze whether the undeniably significant efforts were those of the purchasers or those of the promoter. But, in the present case, Landreth and Cook are not "others" because they were within the control of the purchasers and, therefore, there is no occasion to analyze whether the undeniably significant decisions were made by Landreth, Cook, or the purchasers.